India's Secular Fundamentals Driving Equity Market Performance

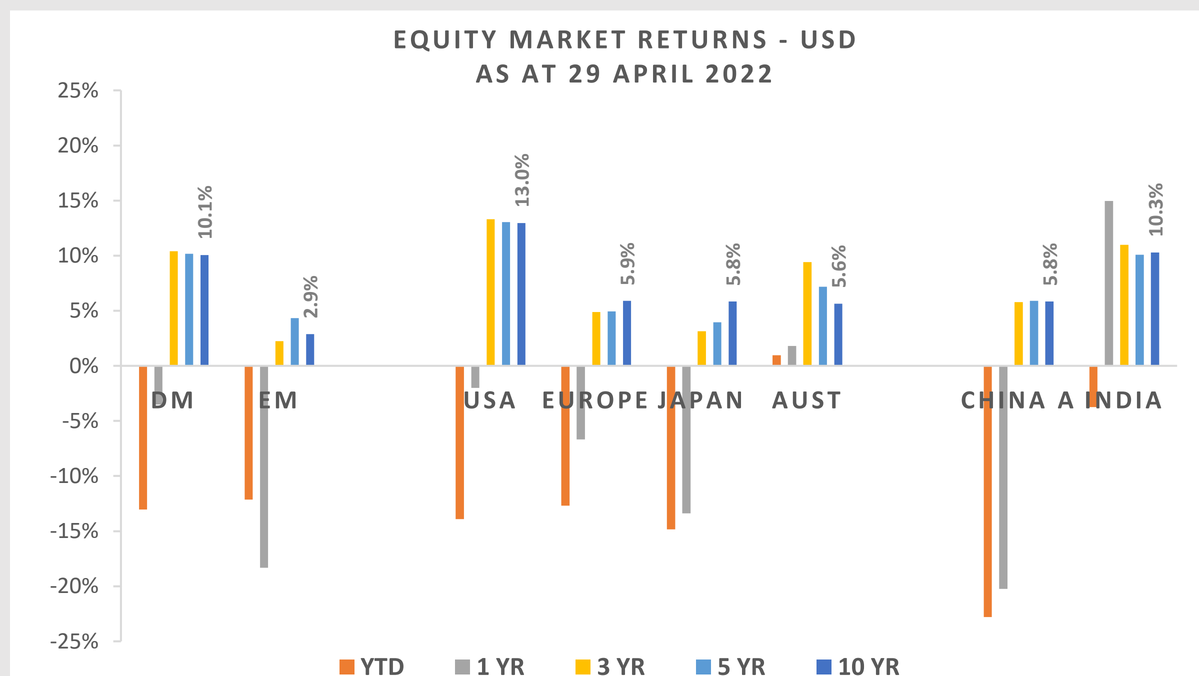
Equity markets, portfolios and investing

Equity markets around the world rose significantly in the decade prior to the sell-off driven by COVID-19 in 2020. In fact, even including COVID-19, over the last 10 years (to 30 April 2022) global equity markets have risen by 10% per annum (in USD terms), fuelled by liquidity, technology and innovation. The clear leader was the US S&P 500, which now dominates global market capitalisation and therefore the MSCI World Index.

Emerging markets, which were expected to be the leaders given their growth fundamentals, were in fact significant laggards. Whilst they spent most of the last decade underperforming Developed Markets quite significantly (2.9% p.a. vs 10.1% p.a.), China became increasingly dominant (over 30% of EM) given its growth and increasing market "openness", by allowing foreign investors to participate.

Most Australian investors in a typical Balanced portfolio would allocate approximately 50% to listed equities. Given the developments of the last decade and traditional strategic allocation patterns of default superannuation options, this would lead to approximately 35% allocation to just three markets – Australia, US and China. Once could argue the case that this covers a significant portfolio of Global GDP and Market Cap, but this might fail on the account of being highly correlated and not achieving broader portfolio diversification.

What worked last time may not next time



Source: MSCI

**Historical returns achieved from equity markets are not a good indicator of future returns. Investors should always seek advice from their financial adviser when constructing investment portfolios.*

Over the last 10 years equity markets have been driven by a discount rate of next to nothing as interest rates fell to ease liquidity post GFC. In such an environment, equity valuations rose, driven by rising P/E's rather than rising earnings. Renewable Energy, Technology, Innovation, Biotech, Mobile Apps, B2C focused companies drove markets given rising valuations and futuristic earnings, with no hurdle rate to think about. Hence the acronym TINA (there is no alternative) came to prominence.

Looking forward, it appears that earnings growth will need to do the heavy lifting in a rising interest rate environment. Equity investors will require greater transparency on earnings and cash flows for company's stock prices to push ahead from here as hurdle rates rise and alternatives become apparent.

India's the Big Sleeper

However, when we look at the returns from various regions/geographies, we can identify that the sleeper has been India. This shouldn't be a surprise given the country's underlying fundamentals of a youthful, large population which has a dropping "dependency ratio" i.e. an increasing employable population relative to dependents.

India's companies (as an aggregate) exhibit extremely low volatility in their yearly earnings achievements (relative to other regions like the US, Australia), given the potential to compound earnings due to the nature of significant and fast-growing addressable markets available for businesses to tap. With India's growing global economic presence and participation in supply chains, the ability for companies to grow earnings should have significant upside as they benefit from their local scale and can use that to leverage their advantages into broader geographies.

India's economy is also on a significant path to "formalisation". Formalisation can be likened to a trend like shopping at a mall compared to a neighbourhood corner store. This trend will provide significant earnings momentum to listed companies operating in most sectors, shifting the balance of profit from small, disaggregated players.

Today India is close to 14% of the weight of MSCI Emerging Markets Index (was 9% five years ago), is approximately 3% of global equity market capitalisation and the world's 5th largest economy. Yet most investors are likely to have less 1% allocation to India's growth story in their default super fund option.

Regional Asset Allocation

Several institutional investors and leading investment consultants continue to view investing in Emerging Markets as a "safer" investment than investing in a single country like India. From a perception view point the case can be made that Emerging Markets presents a broader opportunity set and provides a more diverse range of exposure across economies, which should lead to lower volatility. However, investment portfolios are not assembled in isolation – meaning each asset should not be looked at upon isolation.

Evidence shows that India's equity market correlation with AUD based assets is close to half that of Emerging Markets equities correlation with Australian equities. Is India's growth story an ideal fit for Australian domiciled clients with AUD assets, given its low correlation and secular growth? Evidence over the last 10 years points to this!

In an environment where earnings growth will be critical to maintain and increase share prices, it seems obvious to back fundamentals which are more secular rather than cyclical over the next decade.

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